

S E C R E T SECTION 01 OF 06 MANAMA 000747

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-- POLICY, AND NATIONAL ECONOMIC COUNCIL
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SUBJECT: ISLAMIC BANKING, SHARIAH BOARDS, AND INVESTMENTS
IN THE U.S.

REF: STATE 85235 (NOTAL)

Classified by Ambassador William T. Monroe for reasons 1.4
(b) and (d).

Summary and Comment

11. (U) Islamic banking is a growth industry worldwide and represents a sector for which Bahrain holds a comparative advantage and would like to expand and solidify as a regional center in the Middle East. Bahrain has a strong reputation for transparency and regulation of its financial sector in general, and the Bahrain Monetary Agency (BMA) has endeavored to establish the same stringent monitoring system for the growing Islamic bank industry based in Bahrain. Among the most prominent Islamic banks in Bahrain is Arcapita, formerly First Islamic Investment Bank, because of its track record of investment activity in the United States. Like all Islamic banks, Arcapita's investments are reviewed by a Shariah advisory board of Islamic scholars to ensure its operations comply with Islamic principles. The pool of Shariah scholars is very small; 40 individuals comprise the Shariah boards for 25 Bahraini and Gulf Islamic banks, and there are perhaps as few as 100 of these experts worldwide.

12. (S) We are aware of concerns linking Arcapita advisors and staff to questionable organizations, and that Washington agencies are considering steps to block Arcapita's bid to acquire an American telecommunications company and perhaps other existing Arcapita investments. Action taken against Arcapita could set a dangerous precedent, sending an unfortunate message about U.S. attitudes towards Islamic banking in general. Arcapita's Shariah advisors, for example, sit on the boards of many Islamic banks, including some that are American. We believe such a step in the absence of specific and verifiable information directly linking Arcapita and its investment to extremists could set back United States interests in Bahrain and the wider Arab and Islamic worlds. Most directly, such a step risks undermining the positive benefits that we hope to reap from ratification and implementation of the U.S.-Bahrain free trade agreement. More broadly, it could send a message to the Islamic world that their investments are unwelcome in the U.S. at a time when the United States is working hard to open markets around the world to American business people. Finally, it could degrade our ability to win the war of ideas in Arab and Muslim countries. Islamic banking is a reality; it will increasingly attract funds from Muslim investors. It is in our interest to support a well-regulated and transparent Islamic banking industry.

Strong Regulation, Supervision of Islamic Banks

13. (U) Islamic banking is big business in Bahrain, with an estimated \$4.8 billion in assets in Bahrain as of July 2004. Bahrain hosts 28 Islamic banks and financial institutions. Given the emphasis on Islamic banking, the Bahrain Monetary Agency (central bank) has developed a framework for regulating and supervising the Islamic banking sector, applying regulations and supervision, as it does with respect to conventional banks. In early 2002, the BMA introduced a comprehensive set of regulations for Islamic banks that is designed to monitor capital requirements, governance, control systems, and regulatory reporting, and it is now working towards Basel II Accord compliance. Bahrain is home to the Accounting and Auditing Organization of Islamic Financial Institutions, an industry watchdog established in 1990 that sets standards on accounting, auditing, governance, and transparency, and the Middle East and North Africa Financial Action Task Force, which sets standards for policies on combating money laundering and terrorist financing.

14. (C) BMA Governor Rasheed Miraj told the Ambassador May 22 that the BMA has developed a very effective and strong monitoring system for Islamic banks. What started as a niche industry has grown tremendously in the last few years, said Miraj, as Muslims demanded banking and investment instruments in line with Islamic (Shariah) law, the region experienced strong economic growth, and liquidity increased. He stated that Bahrain and Malaysia are the global leaders in Islamic banking. (Note: The BMA and the Malaysia-based Islamic Financial Services Board work together on standards for and regulation of the industry. End Note.) He expects continued robust expansion in the industry as it develops a wider array of financing and investment instruments to offer clients. Miraj noted that he, along with a representative of the Federal Reserve, had spoken at a session on Islamic banking at the Arab Bankers Association of North America meeting in New York in April and attendance -- some 150 people -- was much larger than had been expected. He said that many international banks in Bahrain, including Citibank, BNP/Paribas, Barclays, Deutsche Bank, and UBS, now have Islamic banking units, and HSBC and other banks are offering Islamic products in the United States. Citibank Middle East Regional Director Mohammed Al Sheroogi told the Ambassador that Citibank established its Islamic banking facility in Bahrain in 1996 because the BMA provides the best regulation of Islamic banking. He considers BMA regulation of the Islamic banking sector to be equal to its regulation of conventional banks.

Islamic Banking Bahrain's "Biggest Success Story"

15. (C) Finance Minister (and until January, BMA Governor) Shaikh Ahmad bin Mohammed Al Khalifa, in a May 18 discussion with the Ambassador, characterized Islamic banking as Bahrain's "the biggest success story." In response to the Ambassador's question, he said Islamic banking does not pose any special challenges with regard to money laundering and terrorism financing. It does, however, require special regulations to account for transactions due to the way risk and profit are accounted for in Islamic banking. The BMA publication "Islamic Banking Review" of April 2005 reported that IMF experts, in Bahrain at the request of the government, had met with representatives of Bahrain's Islamic banking and finance industry as part of a Financial Sector Assessment Program review. Miraj told the Ambassador that the BMA would "come down hard" on any finance institution in Bahrain that was not in compliance with international standards. The stakes are simply too high and Bahrain's future would be put in jeopardy, he said.

16. (U) The first International Islamic Financial Markets (IIFM) Conference, held in Manama May 16-17, highlighted the rapid growth of the sector and its increasing sophistication. The headline announcement was the establishment of a new \$2 billion wholesale Islamic bank due to open in June. The initial paid-up capital will be \$1 billion, rising to \$2 billion in five years, said Izzadine Al Khoja, secretary general of the General Council for Islamic Banks and Financial Institutions. At the conference, Miraj stated that the sovereign Islamic bond market ("sukuks") had expanded across the Gulf and stood at about \$4 billion at the end of 2004. Bahrain's sukuk program alone was over \$1 billion.

Arcapita Sets Up Shop In Atlanta

17. (U) Among the most prominent Islamic banks in Bahrain, because of its track record of investment activity in the United States, is Arcapita, formerly First Islamic Investment Bank (FIIB) of Bahrain. The bank has a solid reputation in Bahrain's financial circles. According to its website, Arcapita has paid-up capital of \$154 million, of which just under 90 percent is held by some 180 prominent individuals and institutions, mostly from the Gulf region. (Note: The largest shareholder in Arcapita is the General Motors dealer in Saudi Arabia, from the Al Jomaih family. End Note.) Arcapita has \$1.2 billion on its balance sheet and an equity capital base in excess of \$300 million. The bank has completed investments with a total transaction value of \$7.8 billion. It has offices in Bahrain, Atlanta, and London. Former Senator and Ambassador Wyche Fowler of Georgia and Professor Samuel Hayes of Harvard Business School comprise Arcapita's international advisory board. Members of the bank's Shariah supervisory board are Shaikh Abdulla Sulaiman Al Meneea (chair), Dr. Abdul Sattar Abdul Kareem Abu Ghuddah, Justice Taqi Usmani, and Shaikh Essam Ishaq.

18. (U) As described on its website, Arcapita's investment strategy is to act as a principal, utilizing its own funds to complete investment transactions but with the ultimate objective of placing a majority of the equity with its investor base in the Gulf region. CEO Atef Abdulmalik said in a press interview that he leveraged his experience at New

York's Investcorp to develop Arcapita into a "small to medium size Islamic private equity player." The bulk of the bank's business in the years following its establishment in 1996 was located in the southeast of the United States.

Arcapita: 14 Deals in Six Years in U.S.

19. (U) An article in the February 7, 2005 edition of Fortune magazine states that "a string of 14 deals over the past six years has quietly made (Arcapita) the first and biggest Middle East-based investment firm in the U.S. Through its American subsidiary, Crescent Capital Investments, which opened in Atlanta in 1997, (Arcapita) has poured about \$2 billion into the U.S. market." The article notes that Arcapita is one of only four private-equity firms conducting investments in the U.S. in accordance with Shariah law. Some of Arcapita's more prominent investments include Loehmann's department stores, Sunrise Senior Living, Church's Chicken, and Caribou Coffee.

10. (U) The bank's actions related to the Caribou Coffee acquisition highlight just how business savvy it is. As Middle East Banker reported in an early 2003 article, Arcapita's investment in the Minnesota-based coffee company attracted critical public attention and press commentary because of the bank's association with controversial Muslim cleric Yousuf Qaradawi. As a result of the uproar, Arcapita dropped Qaradawi from its Sharia advisory board, satisfying critics such as the Minnesota Jewish Community Relations Council.

Shariah Boards Far From Business Operations

11. (C) BMA Governor Miraj told the Ambassador that Shariah advisory boards are "not involved in operations or decision making" of the banks they advise. Their role is to look at whether a proposed transaction is compliant with Shariah law. He said that Shariah boards are generally composed of 3-5 Islamic scholars who have expertise in banking and finance. Dr. Hussein Hassan, a Shariah scholar and Islamic finance expert, told us at the IIFM conference in Manama that Shariah boards are not involved in day-to-day decision making. They do an annual audit of contracts, randomly selecting various contracts to ensure compliance with Shariah law. If there is a new product, the Shariah board will issue a fatwa, or religious ruling, on whether it is Shariah-compliant. Citibank Regional Director Sherogi said the same to the Ambassador.

12. (C) A senior vice president of the Arab Banking Corporation (ABC) told the DCM May 20 that ABC has an Islamic banking arm, ABC Islamic Banking. The Shariah board is made up of a number of Islamic scholars whose expertise is trade and business within Islamic norms. The ABC Islamic Banking Shariah board meets only once a year, and members each receive \$15,000 per year for their services. He noted that there is a very limited pool of relevant experts, and the ABC Shariah board members sit on several other boards. Within the bank is a Shariah certification office that determines whether a proposed business deal is in compliance with Islam. This certifier handles almost all of the business-related Islamic issues. Only in the case of a proposed deal being unusual or non-routine does the certifier pass the proposal to members of the Shariah board for their input.

Very Small Pool of Islamic Finance Experts

13. (U) Mohammed Tawfiq Kanafani, head of UBS's Islamic banking facility Noriba Bank, told the DCM that he seriously doubts whether the number of Shariah scholars who understand banking is over 100. In an admittedly unscientific survey, the Embassy has identified only 40 Islamic scholars who comprise the Shariah boards of 25 Islamic banks based in Bahrain or the Gulf region, including Arcapita. The four members of Arcapita's Shariah board, Shaikh Abdulla Sulaiman Al Mennea, Dr. Abdul Sattar Abdul Kareem Abu Ghuddah, Justice Taqi Usmani, and Shaikh Essam Ishaq, either individually or in some combination also sit on the boards of 18 of the 25 Bahrain- and Gulf-based banks. These include Citibank Islamic Investment Bank, HSBC Islamic Finance, the Saudi-American Bank, and the Saudi-British Bank. Abu Ghuddah is also a member of the Shariah boards of the Dow Jones Islamic Markets Indexes in New York and UBS in Switzerland; Usmani is chair of the Shariah board for the Dow Jones Islamic Market Indexes and for the Bahrain Monetary Agency; and Ishaq is a director for the Al Baraka Islamic Bank, Bahrain Development Bank, Discover Islam, Middle East Traders, and the Islamic Education Society, all from Bahrain.

14. (S) Islamic banks are encouraged to give charitable

donations. (Note: This is different from "zakat," one of the five pillars of Islam, which requires an individual to donate a percentage of his wealth to charity. End Note.) Arcapita reported giving a total \$591,000 in 2003 and \$583,000 in 2002 to a variety of charitable organizations. According to a board member of a charity in Bahrain that receives donations from Arcapita, the Islamic Education Society (Al Tarbiya Al Islamiya - Sunni Salafi) and the Al Islah Society (Sunni Muslim Brotherhood) are the largest beneficiaries of Arcapita's charitable giving, although the contact did not have an idea about the amount of money involved. As noted above, Shaikh Ishaq from Arcapita's Shariah board is also director of the Islamic Education Society. (Comment: Ishaq may be in a position to steer a portion of Arcapita's charitable giving to the Islamic Education Society. We have seen no evidence, however, that he or other Shariah board members play any role in Arcapita's business and investment decisions. End Comment.) The Islamic Education Society and the Al Islah Society are the most prominent and powerful Sunni charity organizations in Bahrain and, according to contacts, it would not be unusual for a large Sunni business to direct a portion of its charitable donations to these Societies.

Denying Deal Could Chill FTA Hopes...

¶ 15. (S) We are aware of concerns linking Arcapita advisors and staff to questionable organizations. Reftel describes the status of the Committee on Foreign Investment in the United States (CFIUS) case 05-17 on Arcapita. We understand that one of the options under consideration by the CFIUS is to block Arcapita's bid to acquire a U.S. telecommunications company. Another option mentioned is investigating the full array of Arcapita's holdings in the U.S. We are not in a position to evaluate fully the information upon which these possible measures are based. We can, however, comment on the policy implications of possible action against Arcapita.

¶ 16. (C) United States relations with Bahrain are characterized by the promotion and strengthening of U.S. interests in Bahrain and region. The over 50-year military relationship, best symbolized by NAVCENT headquarters in Manama, has been the foundation of our bilateral relations. The U.S.-Bahrain free trade agreement (FTA), however, promises to be the catalyst for enhanced economic and commercial relations. While the FTA will undoubtedly promote bilateral trade, investment relations will also grow, including those related to Islamic banking.

¶ 17. (S) Denying Arcapita's acquisition bid could have a chilling effect on the FTA and undermine the positive benefits that we hope to reap from ratification and implementation of the agreement. It could harm the United States' reputation for being open for investment. Such action could be understood by our opponents in Bahrain as blocking the single industry sector in which Bahrain has a clear comparative advantage. It could lead to public calls in Bahrain against the FTA.

...Send Signal Islamic Banking Unwelcome in U.S...

¶ 18. (S) The global presence of Islamic banking is a fact. The industry has experienced strong growth since its inception in the late 1970's. Many Western and American banks have Islamic banking units or subsidiaries. A fundamental requirement of the industry is guidance by Islamic scholars. The pool of Shariah experts who have a full understanding of complex financial and investment instruments is very small, perhaps only 100 people worldwide. Islamic scholars are, by definition, those who look to the Koran for guidance on all aspects of life. Many of these individuals have consorted in the past with those who have descended into extremism and terrorism, but it is more difficult to demonstrate where these ties contaminate business decision-making in the banking sector. As troubling as this association appears, the measures under contemplation by the CFIUS are blunt instruments that may damage U.S. interests without necessarily addressing the core of our concerns. Additionally, action taken against Arcapita due to its Shariah board members could require similar action taken against many other banks, including American banks, because the same individuals sit on the Shariah boards of a large number of Islamic banks. Since 9/11, we have worked diligently to demonstrate that our efforts to combat terrorism financing were not seen as anti-Muslim. We risk undercutting this message.

¶ 19. (S) How we react to Islamic banking's presence in the United States will be watched very carefully. Islamic banking is a new development that could prove to be a bridge between Muslim and Western economies. There could be serious consequences for U.S. decisions to prevent Islamic

investments into the country, with our enemies using these moves to generate propaganda against us.

...And Degrade U.S. Ability to Win War of Ideas

120. (S) More broadly, a policy of stopping Islamic investment in the U.S. would degrade our ability to win the war of ideas in the Arab and Islamic worlds. We could be accused of double-crossing, not practicing what we preach, or being insincere about engaging seriously with Arabs and Muslims. We should be encouraging the person-to-person interaction and engagement that are the hallmarks of business dealings as part of our strategy of promoting liberty and freedom in Muslim countries.

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